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RUEHIL/AMEMBASSY ISLAMABAD 7482
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UNCLAS SECTION 01 OF 04 COLOMBO 001488

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STATE FOR SCA/INS, EEB/IFD/ODF AND EEB/IFD/OMA
STATE PASS USTR FOR ADINA ADLER
COMMERCE FOR JONATHAN STONE
MCC FOR S. GROFF, D. TETER, D. NASSIRY AND E. BURKE
TREASURY FOR LESLIE HULL

E.O 12958: N/A
TAGS: EFIN EINV ECON KMCA CE
SUBJECT: SRI LANKA: DEBUT SOVEREIGN BOND ISSUE RAISES $500 MILLION
DESPITE DOMESTIC CRITICISM

REF: A. Colombo 1218 B. Colombo 1056

¶1. (SBU) Summary and comment: International investors, 40% of them American, purchased all $500 million of Sri Lanka's first-ever sovereign bond issue, despite domestic opposition efforts to block the sale. The government offered 8.25% coupon bonds with a five-year maturity, and received orders from investment bankers in Asia, Europe, and the United States totaling about triple the quantity of bonds for sale. The government cited the strong investor interest as an endorsement of Sri Lanka's economic stability. However, it appears the government chose to set the bond duration to five years because it feared insufficient investor interest in ten-year bonds due to Sri Lanka's instability. As expected, the opposition United National Party's threat that a future UNP government would not honor the bonds appeared to have little impact on investor appetite for the bonds. Nevertheless, the opposition continues to question the government's stated intent to use the bond proceeds entirely to finance infrastructure investment. Central Bank Governor Cabraal assured the Ambassador that the government would indeed use the money for infrastructure. The Rajapaksa government is prone to fiscal irresponsibility, so the opposition's doubts may be justified. On the other hand, the transparency that international investors require to maintain confidence in Sri Lanka's sovereign debt may serve as an effective incentive for fiscal discipline. End summary and comment.

SRI LANKA JOINS THE RANKS OF
EMERGING MARKET BOND ISSUERS

¶2. (U) Sri Lanka successfully sold its $500 million debut sovereign bond issue to international investors the week of October 15. The bond, priced at 8.25% for five-years, was oversubscribed -- investors offered to purchase nearly triple the government's $500 million target. The bond offering was joint lead-managed by JP Morgan, HSBC, and Barclays Capital, and is listed and traded in Singapore. Sri Lankan Central Bank Governor Nivard Cabraal told Ambassador November 1 that U.S. investors had bought 40% of the bonds, with Asian and European buyers taking about 30% each. Prior to the sale, Cabraal and other Central Bank officials joined representatives of the three financial firms for a "road show" to

seven cities in Asia, Europe, and the United States.

¶3. (U) On the road show, Governor Cabraal pitched possible investors on the Sri Lanka "story," which included the following highlights:

- Sri Lanka is poised to grow along with India in fields like information technology and business process outsourcing.

- Sri Lanka's free trade agreements with India and Pakistan position it as both an export and investment platform into those two markets.

- Sri Lanka's resilience -- demonstrated by economic growth of 7.4% in 2006 -- is the untold story of the well-known ethnic conflict.

- The ethnic conflict is confined to the North and East, which cumulatively account for less than ten percent of the economy.

- Sri Lanka has an unblemished debt service record; it is one of only five "emerging market" countries that have never defaulted on domestic or external debt.

¶4. (SBU) JP Morgan's Colombo representative described the successful bond sale to EconOff as remarkable on two counts: both for the strong demand for Sri Lankan debt, and for the fact that this demand existed despite reduced investor interest in emerging market debt following the onset of the sub-prime loan crisis. He noted that this was the first emerging market bond floated since the sub-prime crisis hit, and that its timing was fortuitous, as markets had fallen dramatically during the week after the bond issue. He cited as a critical boost for the bond the Standard & Poor's credit rating agency's August revision of its Sri Lanka rating outlook to "stable" from "negative" (ref A). In the week since the bond was listed in

Singapore, he added, it has traded well -- volume has been good and its price has remained around par.

¶5. (U) (Note: Sri Lanka has sold about $800 million worth of dollar-denominated "Sri Lanka Development Bonds" to international investors, but these were not sovereign bonds tradable in international markets. They were domestic debt sold in Sri Lanka subject to Sri Lankan law and tradable only in the Sri Lankan market. Sri Lanka has also allowed foreign investors to purchase up to 5% of total domestic Rupee-denominated debt, currently totaling about $350 million.)

OPPOSITION CHALLENGE: BOND LIKELY TO BE USED IRRESPONSIBLY AND VIOLATED PARLIAMENTARY PROCEDURE

¶6. (U) The opposition United National Party's threat (ref A) that a future UNP government would not honor the bonds appeared to have little impact on investor appetite for the bonds. Following the sale, the UNP and other critics continued to charge in the media that the bond issue was both imprudent and illegal. They doubted that the government would use the proceeds of the bond to finance infrastructure investment. They claimed that the government could easily have obtained additional concessionary loans from multilateral development banks for infrastructure projects and that therefore the market interest rate and short duration of the bond was an undue burden on public finance. They identified discrepancies in the list of infrastructure projects that the government said it would pursue with the bond proceeds (such as project amounts and whether certain donors had committed funds for the projects.)

¶7. (SBU) Ambassador asked Cabraal about these charges. Cabraal assured the Ambassador that the government would be able to show that it had spent the $500 million on infrastructure. He explained that Sri Lanka has $4.5 billion worth of infrastructure projects in the "pipeline," and that it needed "buffer funds" to avoid unnecessary delays in projects. The Government would use the funds for steps like acquiring land before the start of a project, for example, he said, adding that investors "could see the logic of this."

¶8. (SBU) The opposition and critics also argued that the bond issue had not been conducted in accordance with parliamentary procedure and was therefore illegal. (Comment: Post's review of this charge suggests that it would make a good constitutional case -- there appear to be reasonable points both in favor of the government's right to proceed with such debt financing and also in favor of Parliament having a role in the matter, which it basically did not. The claim that the bond sale was illegal simply because it violated the 2003 Fiscal Management Responsibility Act is less convincing, since the act sets forth "objectives" for spending, debt, and deficit, not actual limits.)

GSL: TRUST US, BOND PROCEEDS FOR INFRASTRUCTURE,
NOT DEFENSE OR CURRENT SPENDING
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¶9. (U) The Government continues to insist that it intends to spend the bond funds on infrastructure projects. The offering circular for the bond stated:

"The Government will use the net proceeds from the issue of the Bonds to supplement available concessional funds to develop infrastructure projects that have been previously approved by the Government and included in the current 2007 Budget. Such infrastructure projects include but are not limited to: electricity generation, transmission, distribution, and substation facilities; roads and bridges; water supply, sanitation and sewage facilities; port facilities; and highways and railway lines.... A portion of the net proceeds will be used for bridging finance for such projects.... Nevertheless, the Government is subject to budgetary and funding limitations and there is no assurance that all the net proceeds will ultimately be used only for these projects."

¶10. (SBU) A mid-level Central Bank source explained to EconFSN that the final clause was included not to give the government wiggle room to spend the funds on whatever it wants, but to allow the government to use the money for temporary purposes until it is needed for specific projects.

BOND WILL EASE PRESSURE ON RUPEE AND
INTEREST RATES, BUT COULD ADD TO INFLATION

¶11. (U) The Central Bank asserted in its October monetary policy statement that the bond sale would ease recent Rupee depreciation, high interest rates and high inflation. Indeed, since the issuance of the bond, the Rupee has strengthened against the dollar to about 112 from a low of about 114 on October 14 (just before the bond sale). The prime lending rate is now 17.6% after having reached 20.5% on October 10.

¶12. (SBU) Comment: The strengthening of the Rupee follows from there now being a greater supply of dollars in Sri Lanka. The easing of interest rates follows from the government's reduced need to borrow funds domestically. However, the Central Bank's assertion that inflation will ease due to the stronger Rupee's effect in reducing the cost of imports is probably too optimistic. The influx of dollars, when converted to Rupees and given to the government, will add to the money supply and thereby contribute to the demand-driven portion of Sri Lanka's current 17% inflation. This could be avoided if the Central Bank "sterilizes" by selling local bonds and thereby absorbing Rupees from private hands. However, a senior Central Bank official told Econoff he doubted the Bank would fully sterilize the influx.

BOND WON'T SERIOUSLY ADD TO SRI LANKA'S
FOREIGN CURRENCY DEBT BURDEN

¶13. (SBU) Critics cited the large figures for Sri Lanka's total outstanding external debt (about $12 billion) and external debt as a percentage of GDP (about 46%) as additional reasons that the bond sale was imprudent. While true that Sri Lanka owes a lot of money

both domestically and externally, the $500 million bond will not drastically change Sri Lanka's overall debt service burden. Sri Lanka's debt service ratio of 12.7% (2006) is manageable because a large majority of its external debt -- about 96% -- is on concessionary terms. Nor is the country in imminent danger of a balance of payments crisis. Sri Lanka consistently runs a balance of payments surplus thanks to continued strong inflows of remittances, donor funding, and even growing foreign direct investment. It receives little portfolio investment -- so called "hot money" that could be pulled out quickly if the country lost favor with investors. Thus Sri Lanka's balance of payments surplus and its ability to service this debt and the rest of its debt appears secure -- all reasons why international investors snapped up the bonds with their attractive 8.25% return.

COMMENT: AN "EXERCISE IN FISCAL DISCIPLINE"

¶14. (SBU) The opposition and other critics are not wrong to be concerned that the government would use the money irresponsibly. The Rajapaksa government is likely to spend the money on projects run by state-owned or -connected enterprises that are inefficient and, in some cases, incompetent. It is likely to pursue projects that Americans would recognize as political "pork" designed to deliver benefits to favored constituents, not to be economically viable. In fact, these are reasons why the critics were wrong to charge that the government could easily have received more concessionary loans for the infrastructure it wants to build. It could not have, because donors like the Asian Development Bank and World Bank would not finance the types of projects the government wants, though they are already financing plenty of infrastructure and other projects here. The government may also be tempted to spend some of the money to cover current expenses like salaries for

the bloated civil service and subsidies for the loss-making Ceylon Electricity Board and Ceylon Petroleum Corporation. As long as it continues to run a budget deficit, it will have to borrow from somewhere to cover such costs. In financial terms, it is not significant whether money used for these particular expenses is borrowed at home or abroad.

¶15. (SBU) More significant would be if the government uses the dollars it raised in the bond sale to finance weapons purchases, which generally must be paid for with hard currency. The local HSBC head told EconOff that he directly warned the government against this when HSBC first evaluated whether to seek the bond management role. He said use of the bond proceeds for military procurement would be the surest way to lose investors' confidence and willingness to purchase future debt.

¶16. (SBU) Ironically, the government's likely interest in returning to international markets to borrow more in the future is the main factor that could keep it from frittering the money away on useless infrastructure, current expenses, or military hardware. As the JP Morgan rep told EconOff, the government being free to do what it wants with the money makes the bond sale an "exercise in fiscal discipline." With credit ratings services scrutinizing Sri Lanka's accounts, he asserted, investors will know before long if the government fails to spend the money wisely. Thus, while we share concerns that the Rajapaksa government may not use the money responsibly, we think the long-term implications of the government's borrowing in international markets could be healthy for Sri Lanka, by creating a functional incentive for greater transparency and accountability.
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